Chapter 17 - Economic and Monetary Policy

- Position of the Working Group of the National Convention on the European Union -

March 2021

This document was made as a presentation of the initial positions of the Working Group of the National Convention on the European Union for Chapter 17 - Economic and Monetary Policy, and for the purpose of the meeting with the representatives of the European Commission held on March 11, 2021.

We thank the members of the working groups for their expert contribution, the National Convention on the European Union and the European Commission for the opportunity to express our views, and we look forward to future cooperation.

Summary

Although Serbia has achieved notable macroeconomic performance, there has been a growing macroeconomic imbalance, a lack of progress in strengthening the country's capacity, and an intention to pursue complex economic policies needed to address the underlying structural factors.

Serbia's business environment is fundamentally discouraging to domestic entrepreneurship. The weak rule of law together with unclear lines of accountability within the public administration, compound the overall environment of uncertainty with an ineffective administration. A decade-long single-minded focus on attracting large-scale employers, with little regard for environmental or developmental implications is by definition burdensome to SMEs, of which the domestic economy is overwhelmingly comprised.

The macroeconomic policy response to the challenges posed by the pandemic also reflected important capacity limitations. While the fiscal and monetary packages in response to the pandemic were broadly adequate, the fiscal packages have come at an unnecessarily high cost and were unique in 2020 in that they made almost no effort to target either the businesses or the population most in need.

Positions of the Working Group of the National Convention on the European Union

As is well known, in 2020 Serbia posted a notable macroeconomic performance, suffering one of the smallest GDP declines in Europe (only -1,1%), while inflation was kept within the projected band (1,2%), the country's foreign exchange reserves were little changed and although there is a sharp increase in the fiscal deficit, the public debt level was kept below the Maastricht 60% limit. After a brief discussion of the factors underlying driving growth, we here highlight some emerging risks and the fundamental policy and systemic limitations that threaten the sustainability of Serbia's growth.

Three factors have contributed to Serbia's strong growth performance. One has been Serbia's economic structure, with a relatively low share of the industries most affected by the crisis, such as tourism and entertainment, and a high share of those least affected--such as government services and agriculture.[1] Also, the fiscal space created in the past years allowed for an increase of the fiscal deficit to -8% of GDP without jeopardizing Serbia's access to international capital markets. This largely redistributive spending came on the back of a sharp increase in public wages effected at the end of 2019. Together, these helped support consumption throughout the crisis.[2]

Most importantly, the year started with a growth momentum that had been gathering for some time, driven primarily by increasingly significant levels of FDI and to which more recently public investment was also added. These factors did not much abate in 2020. In good measure, foreign investor interest is explained by the yawning gap between Serbia's productive capacity and wage levels. After nearly a decade of largely stagnant wages, the Western Balkan region has become very attractive compared to its competitors –the new EU member states and the Far East. There, real wages have been enjoying long-term growth. Also, Serbia appears to be benefiting from its geo-political position--at the doorstep of the EU, yet with strong ties to other regional trading blocs. Belgrade, in particular, has been enjoying a real estate investment boom at least in part owing to this position.

However, this accelerating performance is once again accompanied by growing macroeconomic imbalances and we see no progress in Serbia's capacity or intent to pursue the complex economic policies needed to address the underlying structural factors. The current account deficit has more than doubled; the real exchange rate keeps appreciating while Serbia's dependence on external capital is among the highest in Europe. Most importantly, the market for skilled labor has evidently become a serious bottleneck—with unit labor costs in industry increasing very sharply (23,5%) over 2017-2019 in an environment of in fact *declining* average productivity in industry, and stagnant in the economy overall. Much too large a share of total investment has been comprised of construction, fostering domestic demand and likely not making a proportional contribution to the country's productive capacity. Meanwhile, domestic capital investment continues alarmingly low, with no significant policies in support of its productivity in sight.

In fact, Serbia's business environment is fundamentally discouraging to domestic entrepreneurship. The weak rule of law together with unclear lines of accountability within the public administration,

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[1]This structure also means terms of trade dynamics -- with a rise in global prices of agricultural and metal commodities and decline in those of energy prices-- were favorable in 2020.

[2]The wage increases also had a direct, essentially accounting positive effect on GDP of nearly 1 p.p.

compound the overall environment of uncertainty with an ineffective administration. The conduct of business all too often depends on parallel channels of decision-making, further exacerbating politicization. Among the many consequences that this has, it greatly discourages SME investment and entrepreneurship and it further weakens administrative capacity over the longer run. Policy initiatives to build competitiveness or extend the benefits of foreign investment, while mitigating its negative effects, are marginal.

In fact, key investment promotion policies have the reverse effect. A decade-long single-minded focus on attracting large-scale employers, with little regard for environmental or developmental implications is by definition burdensome to SMEs, of which the domestic economy is overwhelmingly comprised. A red carpet is rolled out for large, typically foreign, investors short-circuiting rather than resolving administrative barriers. This is increasingly hard to justify as unemployment levels have fallen into the single digits, partly owing to intense emigration. The domestic economy, already suffering the well-known SME disadvantages, is hence additionally disadvantaged, both when reaching for administrative attention and resources, and in its efforts to develop/engage skilled labor.

The macroeconomic policy response to the challenges posed by the pandemic also reflected important capacity limitations. While the fiscal and monetary packages in response to the pandemic were broadly adequate, the fiscal packages have come at an unnecessarily high cost and were unique in 2020 in that they made almost no effort to target either the businesses or the population most in need. Only in the third package, currently under implementation, are the most affected sectors extended more help, but this is part of a broader assistance of questionable effect to the entire private corporate sector. Instead of developing mechanisms to deliver truly solidary support to segments of the economy and of the population most affected by public-health management measures, Serbia has opted to limit the scope of the public-health measures. Unfortunately, there are no reliable data on the cost of this policy in terms of health impact on the population at large, and medical professionals in particular.

Considering that the assistance packages were rather simply formulated, it is also noteworthy that it took Serbia much longer to formulate and implement the first package than any other country in the region. In fact, the first additional liquidity began to reach businesses only at the very end of the first lockdown. There is little doubt that this was the result of decision-making bottlenecks resulting from Serbia's extremely centralized (in addition to parallel) policy decision-making process.

To build sustainable growth foundations, Serbia needs to put all its entrepreneurs and investors, domestic and foreign, large and small, on a level playing field, framed by clear principles and rules of market and policy behavior. It needs to seriously confront politicization, racketeering and corruption and build public trust and administrative capacity for the decentralized and principled conduct of policies. Only thus can it develop the constructive public-private cooperation that removes bottlenecks, builds productivity, and promotes brain circulation rather than brain-drain. Only thus can Serbia's economy attain the competitiveness and resilience needed of an economy ready for membership in the EU.

About the Working Group of the National Convention on the European Union for Chapter 17

CEVES has been the coordinator of the working group for this chapter since December 2020. In addition to Kori Udovicki, who participates in the work of this working group on behalf of CEVES, members of the working group are Dr. Milojko Arsic, professor at the Faculty of Economics in Belgrade, Dr. Petar Veselinovic, dean at the Faculty of Economics in Kragujevac, Dr. Milan Nedeljkovic, dean at FEFA, Belgrade, Miloš Janjić, CEP representative, Branko Drčelić, NALED representative, Velibor Tatić, economist.